Asian Studies Center

Backgrounder

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No. 148

May 16, 1997

BEYOND THE MFN DEBATE: A COMPREHENSIVE TRADE STRATEGY TOWARD CHINA

INTRODUCTION

The economic transformation under way in the People's Republic of China (PRC) is reshaping the global economy. Since the initiation of economic reforms in December 1978, the PRC has evolved from a moribund command economy with insignificant international trade and investment flows to a rapidly growing mixed economy. The implementation of economic liberalization over the past 18 years has stimulated international trade and investment with China. Today, the PRC ranks as the world's third-largest economy and tenth-largest trading power.

China's importance to the world economy is likely to grow in future years. A 1994 World Bank study[1] has compared China's economic performance to that of the United States from 1870 to 1900, Japan from 1950 to 1980, South Korea from 1960 to 1990, and Taiwan from 1960 to 1990 during their periods of rapid industrialization. In 1980, the PRC accounted for only 3.6 percent of the world's gross domestic product (GDP) and 0.8 percent of its exports of manufactured goods. The study estimates that, by 2010, the PRC could account for 15.5 percent of the world's GDP and 6.4 percent of its exports of manufactured goods.

Although China no longer is an autarky, it remains outside the legal framework that governs international trade and investment. In particular, it is not a member of the World Trade Organization (WTO). This legal uncertainty hampers trade and investment with the PRC. China applied to join the WTO's predecessor, the General Agreement on Tariffs and Trade (GATT) in 1986, but negotiations for accession to membership in the GATT and now the WTO have been long and difficult.[2] Beijing apparently seeks WTO membership not only for its economic benefits, but also as a political recognition of China's status as a

1 Andrea Boltho, Uri Dadush, Dong He, and Shigeru Otsubo, "China's Emergence: Prospects, Opportunities, and Challenges," World Bank *Policy Research Working Paper* No. 1339, August 1994, p. 3.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

world economic power. The United States, supported by the European Union (EU) and Japan, insists that China's accession must be accomplished on "commercially viable terms." This means the PRC must agree to adhere to all WTO rules governing trade and investment and, within a reasonably short period of time, assure that its market for imported goods and services is at least as open as those of other newly industrializing countries like Brazil.

Under WTO rules, however, the United States must lift its Jackson–Vanik prohibition and grant the PRC permanent, unconditional most favored nation (MFN) status when it accedes to the WTO or else forego any trade liberalization benefits achieved in the accession protocol. Failure to grant permanent, unconditional MFN status will put U.S. firms and workers at a substantial competitive disadvantage compared with the better access to the Chinese market that their European and Japanese rivals would enjoy.

U.S. policymakers have employed or have threatened to employ unilateral economic sanctions to push Beijing toward better human rights observance, to force changes in such PRC trade practices as intellectual piracy, and to curb sales of nuclear and weapons technology. Although it is true that human rights must be an abiding concern and that a state that respects the freedoms of its own people is more likely to live at peace with its neighbors, it must be admitted that sanctions—however well they may have worked on specific trade issues—have not changed the PRC's egregious human rights behavior. In general, sanctions have been unsuccessful in two out of every three cases in which a "sender" country used economic sanctions against a "target" country to achieve non-economic foreign policy objectives.[3] Unless economic sanctions are crafted very carefully, they will damage U.S. commercial interests without achieving any change in Beijing's policies.[4]

Therefore, integrating China into the global economy is more likely to advance long-range U.S. interests by transforming the PRC into a more peaceful and prosperous member of the family of nations. The PRC depends on trade and investment with the rest of the world to maintain its high rate of economic growth and to improve living standards for the Chinese people. To sustain its current economic expansion, the PRC must bring its laws, regulations, and practices governing trade and investment into line with international norms. In other words, China must introduce the rule of law into its economic affairs. Once these seeds are planted in economic fields, the rule of law can spread over time into other fields like human rights. Americans also may hope that integration into the global economy will build an independent and financially secure middle class in China. The creation of a growing middle class—one with knowledge of freedoms in the world outside—certainly has been the prime engine of democratization in South Korea, Taiwan, and Thailand.

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2 The term "GATT" commonly is used to refer to the multilateral General Agreement on Tariffs and Trade and to the organization that arose from that agreement. To clarify the difference, the following distinctions will be made: (1) GATT 1947 refers to the legal text of the original General Agreement on Tariffs and Trade negotiated in 1946 and 1947 and effective January 1, 1948; (2) GATT 1994 refers to the legal text of the General Agreement on Tariffs and Trade, including the Uruguay Round amendments negotiated from 1986 to 1994 and effective January 1, 1995; (3) GATT refers to the organization that arose out of GATT 1947 and was superseded by the World Trade Organization on January 1, 1995.

3 Gary Clyde Hufbauer, Jeffrey J. Schott, and Kimberly Ann Elliott, *Economic Sanctions Revisited: History and Current Policy* (Washington, D.C.: Institute for International Economics, 1990).

4 *Ibid.*

Similarly, integration into the global economy is likely to give the PRC a greater stake in peace and stability in Asia, which in turn reduces the likelihood of military conflict between China and the United States. In general, integration increases the odds for peace and stability just as truculent isolation does the opposite. It is important to remember, however, that this is hardly inevitable: The Iraq that invaded Kuwait, for example, was well-integrated into the international petroleum economy. The United States still must be prepared for all contingencies.

U.S. policymakers should cooperate with Beijing to complete China's integration into the global economy. Such integration expands the opportunities for U.S. firms to export their goods and services to China. Currently, the paychecks of at least 220,000 American workers depend on exports of goods to the PRC. With trade and investment liberalization, this number could expand greatly. Although openly acknowledging differences that exist on many issues, the United States should refrain from destructive unilateral actions that do not work.

China's integration into the global economy involves four major policy challenges for the United States: (1) determining the terms for China's accession to the WTO; (2) granting permanent, unconditional MFN status to the PRC; (3) crafting effective economic sanctions that will persuade Beijing to curb arms proliferation and improve its human rights record; and (4) monitoring China's implementation of bilateral agreements to open its markets and protect intellectual property rights. To respond to these challenges, the President should:

- **Cooperate with the European Union and Japan** to ensure that China becomes a WTO member on commercially viable terms;
- **Offer to exempt China from the Jackson–Vanik Amendment** in exchange for concessions from Beijing;
- **Evaluate any proposed economic sanction** against China very carefully; and
- **Monitor China's implementation of existing bilateral trade and investment agreements** to prevent any backsliding.

THE DRAGON AWAKENS

The *1997 Index of Economic Freedom* ranks China as having a "mostly unfree" economy.[5] Nevertheless, the economic reforms begun by the PRC in December 1978 following the Third Plenary Session of the Eleventh Central Committee of the Communist Party of China brought China out of economic stagnation. The PRC's economic liberalization program differed substantially from the liberalization programs under way in other countries during the 1980s and 1990s. In China, reform was driven not by free-market ideology, but by a pragmatic assessment of the failure of command economics by the late Paramount Leader Deng Xiaoping and his colleagues. Consequently, the PRC did not attempt a rapid and complete conversion to a market economy. Instead, it moved incrementally, testing proposed reforms in a few regions and later spreading successful reforms throughout the country.

5 Kim R. Holmes, Bryan T. Johnson, and Melanie Kirkpatrick, eds., *1997 Index of Economic Freedom* (Washington, D.C: The Heritage Foundation and Dow Jones & Company, Inc., 1997).

Over the past 18 years, China gradually has introduced market forces, reduced central planning, granted autonomy to economic decisionmakers, opened its economy to international trade and investment, and initiated rudimentary legal reforms to curb arbitrary bureaucratic power over economic transactions. Key areas of reform include agriculture, industry, labor, the rule of law, environmental policy, and fiscal and monetary policies.

Agriculture. In 1979, the PRC introduced the Household Responsibility System to replace rural communes. Individual farmers were granted agricultural plots to manage for up to 50 years in exchange for providing a minimum quota of cotton, grains, or vegetable oils to the state trading monopolies at fixed prices. Farmers were free to sell any excess production on the free market or to state trading monopolies at negotiated prices. Since 1986, the government has wavered between maintenance of the quota system and complete liberalization.[6] As a result, the large productivity gains of the early reform period slowed in later years.[7] Nevertheless, the procurement of agricultural output by state agencies shrank from 70 percent in 1978 to 34 percent in 1992, and the share of agricultural production sold at market prices rose from 5.6 percent in 1978 to 82.7 percent in 1992.[8]

Another serious problem for the PRC is agricultural underemployment, which has given rise to a wandering agricultural proletariat that swarms into China's cities in search of jobs. Still another is the extreme and growing disparity between the wealthier urban areas and poorer rural areas. A 1993 survey by the State Statistical Bureau showed that bank deposits of China's richest 3 percent exceed the combined savings of its 830 million peasants.

Industry. Before reform, China's industrial economy resembled the Soviet Union's economy. State-owned enterprises (SOEs) accounted for 78 percent of all industrial output, almost all urban employment, and 91 percent of investment in fixed assets. Beijing set all prices without regard to relative scarcity or prices on international markets. However, through incremental reforms over the past 18 years, market forces have come into play and have restructured China's industries. The most important change has been the rise of alternative forms of business ownership, especially collectively owned enterprises such as township and village enterprises and urban collectives. Although collectively owned enterprises technically are owned by local governments, they operate as though they were profit-maximizing, employee-owned corporations (similar to rural electric cooperatives in the United States). Unlike SOEs, collectively owned enterprises are not under the supervision of a central or provincial government ministry. They neither receive government subsidies nor provide comprehensive social welfare services. They focus solely on producing marketable products and services at a profit for the benefit of their managers and workers.

In 1995, China had 118,000 state-owned enterprises; 1,475,000 collectively owned enterprises; 5,882,000 private enterprises that employed no more than seven people; and 60,300 other enterprises, including private firms with more than seven employees, foreign-owned firms, and joint ventures between Chinese and foreign firms.[9] By 1995,

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6 Terry Sicular, "Redefining State, Plan and Market: China's Reforms in Agricultural Commerce," *The China Quarterly* No. 144 (December 1995), pp. 1021–1026.

7 For example, production of cash crops ballooned by 14.9 percent a year from 1979 to 1984, while their growth rates slowed to 2.3 percent from 1985 to 1992. See Justin Yifu Lin, Jikun Huang, and Scott Rozelle, "China's Food Economy: Past Performance and Future Trends," in *China in the 21st Century: Long-Term Global Implications* (Paris: Organization for Economic Cooperation and Development, 1996), p. 73.

8 Sicular, "Redefining State, Plan and Market," pp. 1032, 1036.

collectively owned enterprises produced nearly 40 percent of China's industrial output. When combined with the output of private and other enterprises, the share of non-state-sector firms in China's industrial output rose to 66 percent.[10] Because non-state-sector firms were concentrated in light manufacturing, retail, and services while state-owned enterprises were concentrated in heavy manufacturing, telecommunications, transportation, and utilities, SOEs still employed 64.9 percent of China's urban workforce and accounted for 55.7 percent of overall investment in fixed assets.[11] However, many of these SOEs produce large volumes of unsaleable goods. Their equipment is outdated, their management is poor and crony-ridden, and their workers lack any motivation toward efficiency. Even though employment and investment in the non-state sector are rising, it has been estimated that losses from the SOEs are between 2.5 percent and 5.5 percent of China's GDP.

China also has made significant progress toward price deregulation. By 1992, the prices for 65 percent of industrial output and 80 percent of retail sales were market-determined.[12] State regulations and subsidies, however, continue to suppress energy, transportation, public utility, and some retail food prices.

Labor. China has not developed a free labor market. Although a system of internal passports, known as Household Registration, is officially in place, its limit on labor mobility is collapsing under the onslaught of 130 million unemployed or underemployed rural laborers seeking jobs in the cities. Urban labor markets are bifurcated. The *Danwei,* or "iron rice bowl," system inhibits the mobility of employees in government ministries or SOEs through lifetime employment commitments, above-market wages, and the extensive provision of social welfare services through the employer. In the non-state sector, wages and working conditions are market-determined. Urban employment grew faster in the non-state sector (8.6 percent) than in the state-owned enterprises (4.2 percent) in 1995.[13]

The PRC bans the organizing of free and independent labor unions. Moreover, a number of Chinese firms have been accused of using forced labor to produce goods for export in violation of international agreements.

Rule of Law. Unlike a centrally planned system that operates on administrative decrees, a market economy requires an elaborate legal and regulatory framework to set the "rules of the game" under which individuals and firms freely compete. In the past 18 years, China has made some progress toward establishing a rule of law in its commercial affairs, but much remains to be done. In particular, China enacted contract, company, and bankruptcy laws; commercial banking, insurance, and securities laws to regulate financial markets; and patent, copyright, and trademark laws to protect intellectual property rights. Although most of these statutes are adequate, enforcement is lacking. Provincial leaders freely ignore laws and regulations promulgated in Beijing. Moreover, because the PRC lacks a truly independent and impartial judiciary to arbitrate disputes, business executives must rely on their connections in the bureaucracy to get things done. As a result, corruption is pervasive.

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9 *China Statistical Yearbook 1996* (Beijing: China Statistical Publishing House, 1996), p. 401.

10 *Ibid.*

11 *Ibid.*, pp. 87, 140.

12 Michael W. Bell, Hoe Ee Khor, and Kalpana Kochhar, "China at the Threshold of a Market Economy," International Monetary Fund *Occasional Paper* No. 107, September 1993, p. 27.

13 *China Statistical Yearbook 1996*, p. 90.

Environmental Policy. China suffers severe environmental degradation. Concentrations of sulfur dioxide and suspended particulates in the air are well above safe levels. Most rivers are little more than open sewers because only 4 percent of municipal wastewater flows receive any treatment. Below-market prices for energy and water—the result of subsidies and poorly defined property rights in natural resources—encourage waste. Environmental regulations, particularly on collectively owned enterprises, are lax. To help redress its environmental problems, Beijing increased spending on pollution control from 0.4 percent of GDP in 1980 to 0.67 percent in 1992; but upgrading municipal water and wastewater systems to international standards alone will require additional expenditures of approximately 1.7 percent of GDP per year over the next ten years, and full remediation of existing environmental problems will cost tens of billions of dollars.[14]

Fiscal and Monetary Policy. Over the past 18 years, China's fiscal and monetary systems have been restructured to resemble more closely those of other low-income developing countries. Beijing has introduced a personal income tax, a company income tax, and a value-added tax to reduce its dependence on revenue from state-owned enterprises. It also has reestablished a government bond market to finance its budget deficit. China's general government expenditures of 14.1 percent of GDP compare favorably with an average of 31.7 percent in other low-income developing countries. However, the transfer of social welfare expenditures from SOEs to the government and the ongoing need to fund education, infrastructure, and pollution control will cause general government expenditures as a percent of GDP to rise in line with those of other developing countries.

A central bank, the People's Bank of China, has been established. Open market operations (the buying and selling of government bonds to control the money supply and, eventually, the inflation rate) were initiated in April 1996. Before that time, the People's Bank of China relied on an administratively determined credit plan to affect the overall price level in the economy. Because Beijing has pressured the People's Bank of China to extend credit to state-owned commercial banks to support their loans to money-losing state-owned industries, inflation has been a persistent problem, peaking at 21.7 percent in 1994 before decelerating to approximately 6 percent in 1996.

THE EFFECTS OF ECONOMIC LIBERALIZATION

Domestic liberalization has caused China to evolve from a stagnant command economy to a rapidly growing mixed economy. China is now the world's third-largest economy behind Japan and the United States. In 1996, GDP was an estimated $837 billion, or $687 per person, based on current exchange rates.[15] Liberalization has stimulated international trade with China. In 1978, China's global two-way merchandise trade was $20.7 billion, making the PRC the world's 27th-largest trading economy. In 1995, China's global two-way merchandise trade rose to $277.9 billion, and the PRC became the world's 10th-largest trading economy. Two-way merchandise trade between China and the United States grew from $4.8 billion in 1980 to $56.3 billion in 1995. As a result, the PRC is now the fifth-largest trading partner of the United States.[16]

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14 *The Chinese Economy: Fighting Inflation, Deepening Reforms,* World Bank *Country Study,* May 1996, p. 40.

15 "China: Ready to Face the World?" *The Economist,* March 8, 1997, China Survey p. 4.

16 John T. Dori and Richard D. Fisher, Jr., eds., *U.S. and Asia Statistical Handbook, 1996 Edition* (Washington, D.C.: The Heritage Foundation, 1996).

Liberalization has changed both the volume and the composition of China's trade flows. Before economic reform, China exported primarily coal, crude oil, and petroleum products. Liberalization, however, encouraged entrepreneurs to exploit China's comparative advantage in abundant low-skilled labor. China's exports now are concentrated in such labor-intensive, light industrial goods as apparel, footwear, sporting goods, textiles, and toys. Using imported parts, China also is assembling a growing number of consumer electronic products like radios, televisions, and telephones for export.[17] As a result, exports of manufactured goods rose from 49.7 percent of total Chinese merchandise exports in 1980 to 85.6 percent in 1995.[18] Liberalization likewise has encouraged China to import goods that reflect the comparative advantages of other countries. Imports are concentrated in such capital-intensive and knowledge-intensive industrial goods as aircraft, computers, electric generators, and telecommunications equipment.[19] Imports of manufactured goods rose from 27.2 percent of total Chinese merchandise imports in 1980 to 81.5 percent in 1995.[20]

Liberalization has invigorated foreign direct investment with China as well. In 1995, the PRC had signed contracts for foreign direct investment totaling $91.2 billion, with $37.5 billion already utilized.[21] Most of this investment (67.6 percent) originates in other parts of the Chinese Economic Area, specifically Hong Kong, Macau, and Taiwan. Foreign direct investment is critically important to China's development plans.[22] Indeed, foreign-invested enterprises account for an usually high percentage of China's exports—31.5 percent in 1995.

CHALLENGES TO SMOOTH INTEGRATION

China must overcome two interrelated internal challenges to sustain its rapid economic growth and ensure its smooth integration into the global economy. First, the PRC must reform its highly inefficient state-owned industries. Second, it must create a modern, efficient financial services sector. China's slow and uncertain response to each of these challenges has complicated both its bid to join the WTO and its bilateral relations with the United States.

Inefficient State-Owned Industries. Despite the rapid expansion in the number of small private firms, cooperatives, and foreign joint ventures, China still had 118,000 state-owned enterprises in 1995.[23] The expanding non-state sector reduced the SOEs' share of China's industrial output from 64.9 percent in 1985 to 34 percent in 1995,[24] but SOEs continued to employ 112,610,000 people, or 64.9 percent of China's urban workforce.[25]

By any measure, state-owned industries are highly inefficient.[26] Almost 50 percent of all SOEs lose money. As a result, Beijing must subsidize many state-owned firms through

17 Nicholas Lardy, *China and the World Economy* (Washington, D.C.: Institute for International Economics. April 1994), pp. 29–33.
18 *China Statistical Yearbook 1996*, p. 579.
19 Lardy, *China and the World Economy*, pp. 29–33.
20 *China Statistical Yearbook 1996*, p. 579.
21 *Ibid.*, p. 597.
22 *Ibid.*, pp. 598–599.
23 *Ibid.*, p. 401.
24 *Ibid.*
25 *Ibid.*, p. 87.
26 World Bank, *The Chinese Economy: Fighting Inflation, Deepening Reforms*, pp. 15–17.

(1) budget outlays intended explicitly to cover operating losses; (2) other budget outlays purportedly intended for capital expenses but quietly redirected to cover operating losses; and (3) low-interest policy loans from state-owned commercial banks. The World Bank estimates conservatively that total subsidies amounted to 3.9 percent of GDP in 1994.[27]

China's efforts to reform state-owned industries have been hampered because of the social welfare functions these industries must perform. Specifically, Beijing has required that SOEs guarantee their workers lifetime employment. Consequently, SOEs are forced to retain more than 15 million redundant workers.[28] These enterprises also supply such social benefits as schools, hospitals, old-age and disability pensions, food services, and retail shops for their workers. Finally, they provide housing for 93 percent of their workers and 51 percent of all urban residents. Taken together, these social welfare burdens amount to 6 percent of SOEs' total costs and 44 percent of their employment costs.[29]

China has tried to improve the economic performance of its state-owned enterprises by introducing competition between state-sector and non-state-sector firms and granting autonomy to state-sector managers. To replace direct state supervision, however, China has not implemented either the internationally accepted standards for financial accounting[30] or a modern system of corporate governance (the laws, regulations, and practices that govern the relationships among a firm's shareholders, board of directors, and managers to ensure that directors and managers act to maximize shareholder wealth rather than to pursue other objectives). As a result, decentralized decisionmaking too often encourages managers to enrich themselves through the stripping of assets or other opportunistic behavior at the expense of the state.[31]

The weakness of China's state-owned industrial sector hampers Beijing's efforts to integrate China's economy into the world trading system. Beijing fears that rapid integration will undermine non-competitive SOEs. It has been reluctant to cut through the web of non-tariff barriers, investment restrictions, and discriminatory practices that protect these industries.

Insolvent State-Owned Financial Institutions. This weakness of China's state-owned industries leads directly to Beijing's second major challenge: restructuring its financial services firms. Over the past 18 years, China has moved beyond the monopoly of a single state-owned bank that provided all central banking, commercial banking, and insurance services. While central banking functions remained in the People's Bank of China, commercial banking functions were devolved into four state-owned commercial banks, and three smaller state-owned policy banks were established to provide subsidized credit to favored borrowers. Insurance is sold through a separate state-owned People's Insurance Company. Although these state-owned giants still dominate the financial services market in China, competition from 13 recently established commercial banks, more than 55,000 credit cooperatives, and more than 350 representative offices of foreign banks, insurance companies, and investment companies is growing. China now operates stock exchanges in Shanghai and Shenzhen. Seventeen regional securities trading centers and hundreds of

27 *Ibid*., pp. 17–18.

28 *Ibid*., p. 17.

29 Harry G. Broadman, "Meeting the Challenge of Chinese Enterprise Reform," World Bank *Discussion Paper* No. 283, April 1995, p. 9; World Bank, *The Chinese Economy: Fighting Inflation, Deepening Reforms*, p. 20.

30 These accepted accounting practices are known as the Generally Accepted Accounting Principles.

31 Broadman, "Meeting the Challenge of Chinese Enterprise Reform," pp. 19–30.

private securities brokers, dealers, and underwriters complete China's financial services sector.[32]

China's financial services firms are highly regulated. The People's Bank of China still controls commercial bank lending through a credit plan that determines the aggregate loan volume for each bank and channels credit to favored sectors or even individual borrowers. Beijing mandates below-market ceilings on interest rates for loans to favored sectors or borrowers,[33] and its credit plan and ceilings on interest rates force commercial banks to provide subsidized loans to keep unprofitable state-owned industrial enterprises in business. Indeed, 90 percent of the approximately $595 billion in commercial bank loans outstanding at the end of 1994 involved loans to SOEs.

Unprofitable state-owned industries have accumulated mountains of debt that they are unable to service, let alone repay. At least one-third of all outstanding commercial bank loans are non-performing (more than 90 days late in interest payments), and more than 50 percent of these non-performing loans are unrecognized losses (bad loans that never will be repaid but have not been declared losses and removed from a bank's balance sheet). The People's Bank of China admits that Chinese commercial banks have approximately $79 billion in unrecognized losses. Because the combined equity and loan loss reserves at Chinese commercial banks were only $27 billion, recognizing the publicly admitted unrecognized losses not only would push the entire Chinese banking system into insolvency, but also would wipe out a significant portion of the savings of the Chinese people.[34]

Private-sector analysts believe that the potential losses banks would suffer if the state-owned industries were restructured would be even larger.[35] By contrast, the bad debt losses from the savings and loan collapse in the United States amounted to 2 percent of GDP, while the bad debt losses from Japan's banking crisis are estimated to be about 10 percent of GDP. Moreover, the financial condition of China's commercial banks deteriorates month by month as Beijing delays reorganizing its state-owned industries.[36]

Excessive regulation, weak and inexperienced management, and accumulated bad debts render China's state-owned commercial banks, policy banks, and insurance company not competitive with their foreign rivals. As a result, Beijing has been unwilling to open its financial services sector and has limited severely the ability of foreign banks and insurance companies to provide services to Chinese business firms and consumers. Beijing's reluctance to confront its financial crisis has complicated its efforts to become a party to the WTO.

32 *Ibid.*, pp. 25–27.

33 *Ibid.*, pp. 28–29.

34 Nicholas R. Lardy, "China's Economic Transformation," paper presented at conference on "China into the 21st Century," U.S. Army War College, Carlisle Barracks, Pennsylvania, April 1996; *Far Eastern Economic Review*, January 25, 1996, p. 25.

35 Nicholas Lardy of the Brookings Institution estimates that actual unrecognized losses could exceed $265 billion, or more than 32 percent of China's GDP. See "China: Ready to Face the World?" pp. 16–17.

36 *Ibid.*

ACCESSION TO THE WORLD TRADE ORGANIZATION

Despite recent progress, there are substantial disagreements over the terms of China's accession to the WTO. In particular, China disagrees with the EU, Japan, and the United States on (1) the size and scope of tariff reductions and the schedule for lifting non-tariff barriers; (2) the time in which China's export-import licensing scheme, known as trading rights, should be abolished; (3) how to bring China's investment and industrial policies in line with WTO agreements; (4) whether China should accede to the WTO as a developed or developing country; and (5) what safeguards should be available to limit import surges while the WTO accession agreement is being implemented.

Rules of Membership in the WTO

The World Trade Organization in Geneva, Switzerland, was established on January 1, 1995, and superseded the GATT. The WTO establishes the legal framework governing international trade, provides a forum for negotiating multilateral trade agreements, and adjudicates disputes arising from these agreements. In addition, it administers the Uruguay Round Agreements, which include the General Agreement on Tariffs and Trade 1994 (GATT 1994); 12 separate agreements pertaining to trade in goods; the General Agreement on Trade in Services (GATS); and the Agreement on Trade-Related Aspects of Intellectual Property Rights. The WTO currently has 129 members, including the United States; together, these countries account for more than 90 percent of global trade.

All WTO-administered trade agreements are based on two fundamental principles of non-discrimination: MFN and national treatment. Under the MFN principle, every WTO member must apply the same tariffs and regulations to similar goods and services from other members that cross its borders. There are two major exceptions to this principle:

- **First,** WTO members may form a preferential trade agreement (PTA), such as a customs union (for example, the EU) or a free trade agreement (for example, the North American Free Trade Agreement, or NAFTA), provided that (1) a proposed PTA eliminates all tariffs and other trade barriers among its members within 10 years and (2) a proposed PTA covers "substantially all" trade in goods and services among members.
- **Second,** developed WTO members may reduce tariffs on certain industrial goods imported from least-developed members. This exception is known as the generalized system of preferences (GSP).

Under the national treatment principle, once foreign goods and services have crossed its borders, a WTO member may not discriminate against them in favor of similar domestic goods and services. Thus, a WTO member may not apply higher tax rates, impose more stringent environmental, health, and safety regulations, or otherwise act to put foreign products at a competitive disadvantage.

Article XII of the Agreement Establishing the World Trade Organization provides that a WTO member may be either a "[sovereign] state or a separate customs territory possessing full autonomy in the conduct of its external commercial relations." A state or territory applying for membership must submit a memorandum detailing all its laws, regulations, and policies affecting trade and investment. Once this memorandum is submitted, negotiations for entry start on two tracks. In Geneva, the WTO General Council appoints a working party composed of trade negotiators from WTO members to bargain with the applicant

over bringing its domestic laws into line with WTO rules. Simultaneously, the applicant begins bilateral discussions with individual WTO members on tariff reductions and other market-opening issues. Only after the applicant concludes all bilateral negotiations may the working party submit an accession protocol to the WTO's supreme governing body, the Ministerial Conference, for approval. The accession protocol is a statement detailing all of an applicant's trade liberalization commitments.

Technically, accession of new members requires a two-thirds vote of the WTO membership. Article IX of the Agreement Establishing the World Trade Organization states, however, that the WTO "shall continue the practice of decision-making by consensus followed under GATT" and that "where a decision cannot be arrived at by consensus, the matter shall be decided by voting." The preference for consensus is very strong. Less than a handful of votes have been taken in almost 50 years, including GATT. When a vote does occur, each WTO member has one vote.[37]

Coming to Geneva

The PRC has been seeking to join the GATT, and now the WTO, for almost a decade. Although the Republic of China was an original contracting party to the GATT, it withdrew in 1950 following the Communist victory on the mainland and the Nationalist retreat to Taiwan. Once economic reforms were under way, the PRC sought to resume China's seat in the GATT. China won observer status in November 1982 and formally requested accession to the GATT on July 11, 1986. On February 13, 1987, China submitted a memorandum describing its trading system, the first step toward accession; and on March 4, 1987, the GATT Council established a working party to negotiate China's accession.[38]

Following the conclusion of the Uruguay Round, China launched a major campaign to join the GATT before the end of 1994. Beijing wanted to become a founding member of the WTO, believing that this would amount to political recognition of China's status as a world economic power. The EU, Japan, and the United States, however, insisted that China's accession must be accomplished on "commercially viable terms." Negotiators could not bridge the wide gap between China's positions and the demands of the other major trading powers, so the talks failed to produce an agreement on China's accession.[39]

Almost one year later, on November 10, 1995, then-Deputy United States Trade Representative (USTR) Charlene Barshefsky laid out for Beijing negotiators a secret 13-page "road map" on Chinese accession. This document outlined the full range of WTO commitments and identified the basic issues that China must resolve before it can enter the WTO on a commercially viable basis.[40] The issues to be resolved included tariff reductions, market access, trading rights, investment policy, whether China would enter as a developed or developing country, protection against import surges, and import quotas.

Tariff Reductions and Market Access. A significant gap remains between the current Chinese tariff-reduction offer and the minimum demands of the major trading powers. During the Asia-Pacific Economic Cooperation (APEC) forum Leaders' Meeting in Osaka, Japan, on November 19, 1995, Chinese President Jiang Zemin announced that

37 The European Union casts all votes for its member states as a bloc.

38 Lardy, *China in the World Economy*, pp. 44–47, 141–143.

39 Wayne M. Morrison, "China–U.S. Trade Issues," CRS *Issue Brief* No. 95–IB91121, October 11, 1995, p. 13.

40 "U.S. Softens Demands on China Accession into World Trade Body," *Inside U.S. Trade,* Vol. 13, No. 48 (December 1, 1995), pp. 1, 20–21.

China would cut its average tariff rate from 36 percent to 23 percent as a "downpayment" on APEC trade liberalization.[41] In April 1996, China implemented tariff cuts on more than 4,900 items, including 380 agricultural commodities.[42]

During the November 1996 APEC Ministers' Meeting in Manila, Philippines, China presented its Individual Action Plan (IAP) promising further tariff cuts. Specifically, Beijing promised to lower its average tariff from 23 percent to 15 percent by 2000; eliminate all non-tariff barriers not consistent with WTO rules; and expand market access for foreign service providers over the next four years by expanding the geographic areas in which foreign insurance companies can compete, allowing foreign banks to deal in Chinese currency, and allowing more foreign securities firms to establish offices in China. In a November 23, 1996, briefing in Manila, Barshefsky praised China's IAP but warned that the PRC must do more before joining the WTO: "There is no question that China has moved to open its trade regime. There is also no question that China's trade regime remains highly protected and that trade barriers must come down."[43]

Trading Rights. China controls imports and exports through a licensing system known as trading rights, which requires a firm to receive Beijing's approval for each of its imports or exports. Under the WTO, firms may import or export any product unless that product falls under certain narrowly defined exceptions. Eliminating trading rights is important because China otherwise would be able to negate the value of any tariff concession simply by refusing to grant an import license.[44] In December 1995, China offered to phase out trading rights within five years instead of the eight years it had offered in July 1995.[45] The United States has pushed for a shorter phase-out period—two or three years—provided that China does not favor domestic firms over their foreign rivals in granting trading rights during this period.[46]

Investment and Industrial Policies. China has indicated not only its desire to maintain an industrial policy to protect "infant" industries, but also its unwillingness to liberalize fully its rules regarding foreign investment.[47] China violates, for example, the WTO's national treatment principle by forbidding foreign investment in some industries (such as motor vehicle assembly), requiring local partners in others, and discriminating against foreign firms in granting trading rights. China violates the Uruguay Round's Agreement on Investment by placing performance requirements (such as minimum local content requirements) on foreign investment. These requirements mandate that a minimum percentage of a product's value must be produced within China. In addition, minimum export commitments compel foreign-owned firms to export a large percentage of the products made at their Chinese factories.

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41 "Trade in the Pacific: No Action, No Agenda," *The Economist,* November 25, 1995, pp. 75–76.

42 "China Tariff Package Included Farm Products, Thirty-Four New TRQs," *Inside U.S. Trade,* Vol. 14, No. 14 (December 8, 1995), pp. 27–28.

43 "China Announces New Tariff Cuts in APEC Action Plan," *Inside U.S. Trade,* Vol. 14, No. 48 (November 29, 1996), pp. 6–7.

44 *China's Accession to the WTO/GATT: Trading Rights* (Washington, D.C.: United States Business Council, September 15, 1995), pp. 1–4.

45 "China Offers to Speed Up Tariff Cuts, Change Trading Rights Proposal," *Inside U.S. Trade,* Vol. 13, No. 49 (December 8, 1995), pp. 1, 18–19.

46 "U.S. Softens Demands," p. 1.

47 "Chinese Negotiators Fail to Offer Response to U.S. Roadmap," *Inside U.S. Trade,* Vol. 13, No. 50 (December 15, 1995), pp. 1, 26–27.

China also violates the Uruguay Round's Agreement on Intellectual Property Rights by requiring the transfer of patented technology as a precondition for approving foreign investment. Chinese ministries now are developing new industrial policies that could harm U.S. economic interests. In semiconductors, the Ministry of Electronic Industries and the Ministry of Foreign Trade and Economic Cooperation ration the granting of import licenses to U.S. firms as the *quid pro quo* for their specific technology transfer requirements. In autos, China has prohibited wholly foreign-owned production, limited the number of joint-venture assembly plants, and required substantial technology transfer from such foreign partners as Mercedes-Benz. In aviation, China restricted commercial jet sales unless Boeing and Airbus Industries transferred some of their manufacturing operations to China.[48]

The EU, Japan, and the United States insist that China terminate these practices upon accession to the WTO, while the Chinese want a much longer phase-out period.

Developed versus Developing Country. China seeks to enter the WTO as a so-called developing country. The WTO tries to help developing members adjust to global competition by allowing them at times to meet less demanding standards and take longer to implement trade liberalization than developed members. In agriculture, for example, while developed members must cut the value of their export subsidies by 36 percent and the volume of their subsidized exports by 21 percent over six years, developing members must cut the value of their export subsidies by 24 percent and the volume of their subsidized exports by 14 percent over ten years. Similarly, developed members must implement the Agreement on Intellectual Property Rights within one year, but developing members can take up to four years.

China argues that its low per capita income makes it a developing country. The United States and other developed countries counter that China, far from having an economy that is small and weak like those typically found among developing countries, already is a major exporter. Therefore, it should enter the WTO under the more demanding standards of a developed country. At the same time, it should be remembered that the Uruguay Round Agreements phase out most of the "special and differential treatment" that GATT 1947 accorded to developing countries. Therefore, the longer the PRC remains outside the WTO, the fewer the benefits to be conferred by developing country status.

Protection Against Import Surges from China. As China seeks to join the WTO, a significant area of disagreement among the EU, Japan, and the United States concerns the need for safeguards against import surges from China during the phase-in period. WTO members may raise tariffs temporarily or impose quotas for up to four years when (1) an import surge threatens a domestic industry and (2) relief from the import surge may "prevent or remedy serious injury and facilitate adjustment." This is known as a "safeguard." Generally, safeguards must be applied equally to all exporting countries and may not be targeted at a specific country.

EU members insist that, during the transition period while China is still implementing its WTO commitments, WTO members should be permitted to apply safeguards specifically against Chinese exports. The Europeans also want to be able to apply these safeguards either against specific Chinese products or against all Chinese exports. For their

48 Greg Mastel, *Trading with the Middle Kingdom* (Washington, D.C.: Economic Strategy Institute, September 1995), pp. 25–29.

part, the Japanese have shown little interest in safeguards. The U.S. position is more ambivalent. The first preference of the United States is a strong accession agreement. The United States would have China rapidly liberalize its market and adopt strict rules on investment and intellectual property rights. At the same time, the U.S. "road map" suggests a willingness to consider safeguards as a necessary element of accession.

Although China objects to safeguards as a violation of the MFN principle, it does not rule them out entirely. China would allow WTO members to invoke safeguards, but only when the volume of imports of a specific Chinese product grew substantially faster than the volume of imports of similar products from other countries.[49]

Import Quotas. Referring to Poland's accession to the GATT in 1968 as a precedent, the U.S. "road map" suggests that China should consider adopting import quotas while implementing its WTO commitments.[50] During Poland's accession negotiations, GATT members struggled over how to create trading opportunities between Poland's non-market economy and their own market economies. To solve this problem, Poland agreed to increase its imports from GATT members by 7 percent each year. It also promised to subject its exports to GATT members to special safeguards. These import quotas encouraged Polish central planners to permit more imports and to abandon some protectionist policies.[51] China, however, believes that import quotas are inappropriate during the implementation period. As a Chinese negotiator recently stated, "China is in transit from a planned economy to a market economy. Today's China is totally different than Poland thirty years ago."[52]

Negotiating the Stumbling Blocks

The status of China's state-owned enterprises is a major stumbling block for Beijing in making an acceptable accession offer. Over 50 million Chinese are employed in unprofitable SOEs. On June 11, 1996, then-Assistant Secretary of State Winston Lord testified before the House Ways and Means Committee that Beijing had failed to make an adequate offer to open its market during the WTO accession negotiations because the leadership fears that subjecting China's highly inefficient SOEs to competition would cause bankruptcies and mass unemployment, and thus risk political instability.[53]

In testimony before the Trade Subcommittee of the House Ways and Means Committee on September 19, 1996, then-Acting USTR Barshefsky stated that China's market access offers fell far short of what the Clinton Administration believes is necessary to warrant China's accession to the WTO. Barshefsky stated that "China's offers on market access for goods and services are not acceptable in their current form." In addition, a number of important rules issues, such as the right to trade, the removal of non-tariff measures, the manner in which state trading is conducted, disciplines on agricultural supports and subsidies, and China's industrial policies, remain unresolved. Without progress in all these areas, none of the major countries negotiating China's accession terms will be prepared to

49 "Chinese Official Says Roadmap Too Demanding for WTO Accession," *Inside U.S. Trade,* Vol. 14, No. 7 (February 16, 1996), p. 2.

50 "Kantor Says U.S. WTO Paper Does Not Demand Import Targets of China," *Inside U.S. Trade,* Vol. 14, No. 4 (January 26, 1996), pp. 1–2.

51 Mastel, *Trading with the Middle Kingdom,* pp. 39–45.

52 "Kantor Says," p. 2.

53 "Lord Says China's Lack of Good WTO Offer Related to State Firms," *Inside U.S. Trade,* Vol. 14, No. 25 (June 21, 1996), p. 27.

complete the accession. Barshefsky stressed that winning a standstill commitment from China is necessary if negotiations are to move forward: "To make progress, China must stop erecting new trade barriers to replace those previously removed. And it must cease implementing policies that move it further away from WTO consistency." Barshefsky further noted that China had been very slow to respond to the substantive issues raised by the United States in the "road map" for WTO accession that she had presented to Chinese negotiators the previous November.[54]

Bilateral meetings between Assistant USTR Lee Sands and officials from China's Ministry of Foreign Trade and Economic Cooperation in September 1996 yielded little progress.[55] A breakthrough occurred the following month when Assistant Minister of Foreign Trade and Economic Cooperation Long Yongtu promised Sands that China would agree not to impose any new trade barriers while negotiations on joining the WTO were under way during bilateral meetings in Washington.[56]

In a November 1, 1996, session of the WTO working party on China's accession in Geneva, Assistant Minister Long announced formally the "decision of the Chinese government to undertake the principle of standstill and to commit ourselves that China will not promulgate new laws and policies that are inconsistent with the WTO rules during the negotiation process."[57] Beijing put on the table a complete schedule for phasing out all non-tariff barriers. Under this proposal, China would eliminate all non-tariff barriers, including import licensing and quotas, within five years for televisions, refrigerators, and freezers, and within three years for other consumer electronics. Although it is willing to lift all restrictions on cotton and wool immediately, Beijing wants to maintain restrictions on synthetic fibers and yarns for three years. It seeks a 12-year phase-out for heavy equipment, construction machinery, and petroleum-based fuels, and an even longer phase-out period of 15 years for automotive parts and motor vehicles. Although China's time frame for phasing out its WTO-inconsistent policies is much longer than the three to eight years envisioned by the United States, its proposal nevertheless provides a constructive basis for negotiations.[58]

On November 24, 1996, U.S. President Bill Clinton met with Chinese President Jiang Zemin during the Leaders' Meeting of the APEC forum in Subic Bay, Philippines. Clinton acknowledged both China's APEC Individual Action Plan to cut its average tariff rate to 15 percent by 2000 and the new offer on non-tariff barriers made in Geneva. Stressing that China will not be allowed to join the WTO on a political basis, Clinton requested that Jiang improve China's offers on market access and adherence to WTO rules before the next meeting of the WTO working party on China's accession in March 1997.[59]

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54 "Barshefsky Says Chinese Offers Still Fall Short of WTO Threshold," *Inside U.S. Trade,* Vol. 14, No. 38 (September 20, 1996), pp. 1, 25–26.

55 "Barshefsky Says Latest Round of WTO Talks with China Inconclusive," *Inside U.S. Trade,* Vol. 14, No. 39 (September 27, 1996), pp. 1, 28–29.

56 "Chinese Official Offers Standstill Agreement on Trade Restrictions," *Inside U.S. Trade,* Vol. 14, No. 42 (October 18, 1996), pp. 1, 25–26.

57 "China Offers Standstill, New Information About Trading Regime in WTO," *Inside U.S. Trade,* Vol. 14, No. 45 (November 8, 1996), pp. 1, 25–26.

58 "China Tables Complete Schedule for Phasing Out Non-Tariff Barriers," *Inside U.S. Trade,* Vol. 14, No. 45 (November 8, 1996), pp. 5–6.

59 "Clinton Tells Jiang WTO Deal Must Have Commercial, Not Political Basis," *Inside U.S. Trade,* Vol. 14, No. 48 (November 29, 1996), pp. 3–4.

In December 1996, trade ministers from Canada, the EU, Japan, and the United States (the Quad group) met during the WTO Ministerial Conference in Singapore to discuss China's accession. Quad ministers have a "general agreement that China's offers are not adequate and do not form an adequate basis on which to undertake a serious negotiation."[60] Therefore, China must make a "renewed effort" to secure WTO accession.

In January 1997, the Clinton Administration announced that it "will begin an intensive series of meetings with Chinese officials...to ascertain by June whether negotiations on China's accession to the WTO can make substantive progress this year."[61] In her January 29, 1997, confirmation hearing before the U.S. Senate Finance Committee, USTR Charlene Barshefsky reiterated that China had not yet made the sorts of concessions that would warrant accession to the WTO.[62]

Significant progress was made at working group meetings during the first week of March 1997 in Geneva. Beijing promised to adhere to the WTO Agreement on Intellectual Property Rights immediately upon accession, to eliminate trading rights within three years of accession, to end local content and export performance requirements for foreign direct investment by 1999, and to adhere to the higher standards of a developed country when WTO agreements grant developing countries "special and differential treatment" after the accession protocol is fully implemented. EU Trade Commissioner Sir Leon Brittan assessed the results of the meeting: "The EU believes that if all sides muster sufficient political will, the terms of China's accession could be agreed by the end of the year."[63]

CHINA'S MFN STATUS

Once these multilateral questions over China's accession to the WTO are settled, the PRC and the United States must resolve other bilateral trade and investment issues. In particular, Congress must repeal Title IV of the Trade Act of 1974, commonly known as the Jackson–Vanik Amendment, which prohibits the President of the United States from granting most favored nation (MFN) or normal trading status to China on a permanent, unconditional basis.

In international trade, "most favored nation" means simply the non-discriminatory treatment of trading partners. MFN originated in international trade agreements in which each signatory country agreed to extend to all signatories terms "no less favorable" than the terms accorded to the "most favored nation." Thus, it ensures that all signatory countries are treated equally. For example, if the United States were to abolish its tariffs on the import of alcoholic beverages from Japan, it would be obliged at the same time to eliminate its tariffs on such imports from all other WTO members.

MFN is a long-standing concept in U.S. trade law. Prior to 1934, the United States granted MFN treatment to trading partners only within the scope of specific commercial agreements containing MFN clauses. Through the Trade Agreements Act of 1934,

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60 "Quad Rejects EU Proposal for Joint Statement on China WTO Accession," *Inside U.S. Trade,* Vol. 14, No. 51 (December 13, 1996), pp. 3-4.

61 "U.S. to Step Up Talks with China on WTO Accession Through June," *Inside U.S. Trade,* Vol. 15, No. 3 (January 17, 1997), pp. 1, 17–18.

62 "Barshefsky Says Farm Issues Must Be Settled for China to Join WTO," *Inside U.S. Trade,* Vol. 15, No. 5 (January 31, 1997), pp. 1, 21–22.

63 "China WTO Group Develops New Protocol But Moves Little on Market Access," *Inside U.S. Trade,* Vol. 15, No. 10 (March 7, 1997), pp. 1, 26–28.

however, Congress extended MFN treatment to all trading partners. Thus, the United States applied any tariff reductions and trade concessions granted in bilateral agreements to all countries on a non-discriminatory basis. As a signatory to the GATT 1947, the United States has been obliged since January 1, 1948, to grant unconditional, permanent MFN status to all other contracting parties to the GATT and its successor, the WTO, under international law.

Following the outbreak of the Korean War, however, Congress limited the application of unconditional MFN. Section 5 of the Trade Agreements Extension Act of 1951 directed President Harry Truman either to withdraw MFN status from the Soviet Union and all other countries under the control of international communism or to suspend it. Pursuant to this legislation, Truman suspended China's MFN status on September 1, 1951, approximately two years after the founding of the People's Republic of China.

Title IV of Trade Act of 1974, commonly known as the Jackson–Vanik Amendment, reaffirmed the legal ban on granting MFN status to all countries with "non-market economies" (communist governments), except for Poland and Yugoslavia, as of January 3, 1975. The act provides, however, that the President may lift this ban and grant conditional MFN status to a "non-market economy" country such as China if two conditions are satisfied:

- **The President concludes** a bilateral trade agreement with the subject country that provides for reciprocal MFN treatment, includes safeguards against disruptive imports, and includes protection for intellectual property rights; and
- **The President determines** that the subject country permits free and unrestricted emigration of its citizens.

Title IV also provides that the President may waive the requirements for full compliance with freedom of emigration requirements for 12 months if he determines that such a waiver will substantially promote the objective of freedom of emigration. The President may renew such waivers for another 12 months simply by notifying Congress by June 3 of each year unless a resolution of disapproval is enacted within 60 legislative days.

In the process of normalizing relations with the PRC, President Jimmy Carter negotiated a three-year bilateral trade agreement that entered into force on February 1, 1980. This agreement, which satisfied the trade agreement requirement in granting China conditional MFN status, has been extended five times. Carter could not determine, however, whether China fully met the freedom of emigration requirement for extending conditional MFN status. He therefore chose to grant China a 12-month waiver. Every subsequent President has extended the waiver for another 12 months when it came up for renewal in June.

Both the automatic extension of the trade agreement with China every three years and the annual presidential waiver of the freedom of emigration requirement went smoothly through the 1980s. Sino–U.S. relations soured, however, after the June 4, 1989, massacre of students and workers in Tiananmen Square by the People's Liberation Army (PLA). In response, President George Bush imposed a number of economic sanctions on the PRC, including restrictions on arms and munitions sales, military exchanges, transfer of dual-use technologies, and U.S. government financing for projects in China. Bush decided to continue China's MFN status, however, because revoking it would hurt the very people in China—especially entrepreneurs and economic reformers—the United States wanted to

help. Each year from 1990 through 1992, Congress vented its frustration at Beijing by voting to disapprove the President's renewal of China's MFN status, forcing President Bush in turn to veto the resolution of disapproval.

During the 1992 U.S. presidential campaign, then-Governor Bill Clinton lambasted President Bush for "coddling tyrants" and vowed to force the "butchers of Beijing" to improve their observance of human rights by attaching human rights conditions to the renewal of MFN. As President, Clinton issued an executive order on May 28, 1993, renewing China's MFN status for one year but also attaching new human rights conditions to future renewals. Under intense pressure from the U.S. business community, Clinton retreated from this threat and agreed to renew China's MFN status without human rights conditions.

In 1996, the Clinton Administration seemed to be laying the groundwork for granting China permanent, unconditional MFN status in 1997.[64] Then-Assistant Secretary of State Winston Lord noted that China's willingness to live up to its bilateral market access and intellectual property rights enforcement commitments and to put a strong market access offer on the table in WTO accession talks in Geneva would have a "favorable impact" as the Administration decided whether to push for permanent, unconditional MFN status for China in 1997.[65]

Representative Douglas Bereuter (R–NE), Chairman of the Asia-Pacific Subcommittee of the House International Relations Committee, has introduced legislation in the 105th Congress to repeal the Jackson–Vanik Amendment and thereby grant permanent MFN status to China. The bill would allow the President to raise tariffs on exports from non-WTO members to pre-Uruguay Round levels, however, if such countries denied market access to U.S. exports.[66] Representative Philip Crane (R–IL), Chairman of the Trade Subcommittee of the House Ways and Means Committee, strongly supports granting the PRC permanent MFN status but also notes that many Members want to be sure that the transition to Chinese control in Hong Kong does not diminish human rights significantly before extending permanent MFN status to the PRC: "Realistically, a one-year extension [of MFN for China] is the best we can expect."[67] American business groups supporting permanent MFN for China apparently have reached the same conclusion; they are delaying an all-out push for permanent MFN status for China until 1998.[68]

64 "Administration Laying the Groundwork to Grant China Permanent MFN," *Inside U.S. Trade,* Vol. 14, No. 33 (August 16, 1996), pp. 1, 13–14.

65 "Lord Says China's Trade Concessions Connected to Permanent MFN," *Inside U.S. Trade,* Vol. 14, No. 46 (November 15, 1996), pp. 8–9.

66 "Bereuter Immediately Drops Bill to Replace Jackson–Vanik Amendment," *Inside U.S. Trade,* Vol. 15, No. 2 (January 10, 1997), pp. 19–20.

67 "Crane Says Permanent MFN for China Not Realistic in 1997," *Inside U.S. Trade,* Vol. 15, No. 1 (January 3, 1997), pp. 1, 13–14.

68 Business Groups Leaning Toward Delaying Permanent China MFN Push," *Inside U.S. Trade,* Vol. 15, No. 1 (January 3, 1997), pp. 1–2.

ECONOMIC SANCTIONS

U.S. policymakers employ economic sanctions not only to redress trade and investment disputes, but also to achieve non-economic policy objectives.[69] This has been especially true with respect to the PRC. Currently, the United States imposes the following economic sanctions on China:

- **Restrictions on export licenses.** The United States may deny export licenses for products that would make a direct and significant contribution to nuclear weapons and their delivery systems, electronic and submarine warfare, intelligence gathering, power projection, and air superiority (November 23, 1983).
- **Withholding of generalized system of preferences status.** Section 502(b)(1) of the Trade Act of 1974 prevents the President from designating any developing country "dominated or controlled by international communism" as a beneficiary of tariff reductions under this program (January 1, 1976).
- **Suspension of nuclear trade and cooperation.** Section 902 of the Foreign Relations Authorization Act for Fiscal Years 1990 and 1991 codified the suspension of nuclear trade and cooperation with China. This sanction may be lifted if the President determines that China is making political reforms in Tibet (February 16, 1990).
- **Suspension of arms trade and military exchanges.** President Bush suspended government-to-government and commercial arms sales to China (June 5, 1989).
- **Suspension of support for new multilateral development bank loans except to meet basic human needs.** President Bush directed the U.S. directors at the World Bank and the Asian Development Bank to seek postponement of new multilateral development bank loans to China (June 20, 1989), although the United States subsequently has supported extending many multilateral development bank loans to China because they help to meet basic human needs.
- **Suspension of Overseas Private Investment Corporation (OPIC) and Trade and Development Agency (TDA) activities.** Section 902 of the Foreign Relations Authorization Act for FY 1990 and 1991 codified suspension of (1) the granting of OPIC insurance, reinsurance, financing, or guarantees to China and (2) the obligating of TDA funds for new projects in China. This sanction may be lifted if the President determines that China is making political reforms in Tibet (February 16, 1990).
- **Prohibition of the export of items on the Munitions Control List, and of U.S. satellites.** Section 902 of the Foreign Relations Authorization Act for Fiscal Years 1990 and 1991 codified the suspension of exports to China of any defense article on the U.S. Munitions List, as well as any U.S. satellites. This sanction may be lifted if the President determines that China is making political reforms in Tibet (February 16, 1990).

69 Economic sanctions refer to all restrictions placed by the sender country on trade with and investment in a target country that are designed to force the government of the target country to change its non-economic policies. For purposes of this section, restrictions designed to settle an international trade or investment dispute are not considered economic sanctions.

- **Prohibition of export licenses for crime control and detection equipment.** Section 902 of the Foreign Relations Authorization Act for Fiscal Years 1990 and 1991 codified a prohibition on the granting of export licenses for the sale of crime control and detection equipment to China. This sanction may be lifted if the President determines that China is making political reforms in Tibet (February 16, 1990).
- **Prohibition of certain imports produced by prison labor.** The Customs Bureau has enforced Section 307 of the Tariff Act of 1930, which forbids imports made by forced or prison labor (diesel engines manufactured by the Golden Horse Diesel Engine Factory, March 23, 1992; tea grown by the Red Star Tea Farm, July 13, 1992; sheepskin and leather processed by the Qinghai Hide and Garment Factory, July 13, 1992; iron pipe fittings manufactured by the Tianjin Malleable Iron Factory, April 29, 1996).
- **Prohibition of the importation of Chinese munitions and ammunition.** In conjunction with the 1994 annual renewal of China's MFN status, President Clinton prohibited the importing of arms and ammunition from the PRC (May 28, 1994).[70]

Historically, the value of sanctions in forcing policy changes on another government is at best dubious. In South Africa, economic sanctions were in place for three decades before any substantive political change occurred. Even then, change occurred because private banks and industrial corporations went well beyond government-imposed sanctions on new loans and decided to call existing loans and liquidate existing investments.

Imposing sanctions unilaterally, without general cooperation from the international community, tends to isolate the country imposing the sanctions more than the target country. A comprehensive study of all economic sanctions imposed for non-economic purposes between 1914 and 1990[71] found that economic sanctions failed to achieve their stated objectives in 66 percent of the 116 cases studied. In the remaining cases in which sanctions could be classified as at least partially effective, a number of special circumstances were present. In successful or partially successful cases, the sender country was seeking a minor policy change in the target country rather than a major policy reversal such as military withdrawal, change in the head of government, or democratization. The sender country had a historic relationship with the target country like that of a mother country to a colony. The sender country's economy was strong and did not depend on trade and investment with the target country, while the target country's economy was very weak and highly dependent on trade and investment with the sender country. Even when all these conditions were present, the sender country seldom achieved an all-out victory.

This study suggests that unilaterally imposing economic sanctions on the PRC will not necessarily achieve the objectives sought by U.S. policymakers. None of the prerequisites for successful economic sanctions are present in the case of China. China is not small, economically weak, or historically dependent upon the United States; it is a large, independent country with a vibrant economy. It therefore would be unrealistic for U.S. policymakers to expect that unilateral economic sanctions alone would persuade Beijing to democratize or observe human rights. At the same time, however, if they were imposed in

70 Dianne E. Rennack, "China: U.S. Economic Sanctions," CRS *Report for Congress* No. 96–272 F, updated July 1, 1996.
71 Hufbauer, Schott, and Elliott, *Economic Sanctions Revisited: History and Current Policy.*

conjunction with other countries, economic sanctions might persuade Beijing to temper its exports of missiles and nuclear technology to rogue states.

BILATERAL TRADE AGREEMENTS

As China has developed into a trading power, it has clashed with the United States over such trade and investment issues as market access for U.S. exports, apparel and textile quotas, and intellectual property rights protection.

Market Access. Since the mid-1980s, Washington has negotiated periodically with Beijing to reduce China's administrative barriers to imports. In October 1992, China and the United States signed a far-reaching Market Access Memorandum of Understanding (MOU) to settle a pending Section 301 case and begin eliminating Chinese trading policies and practices that are inconsistent with the PRC's long-term goal of joining the WTO.[72] Specifically, China agreed in this memorandum to dismantle 90 percent of its import quotas, reduce its tariffs, and revoke its import-substitution regulations over the next five years; to increase the transparency of its trading regime by publishing all trade laws, regulations, and policies; and to base all of its sanitary and phytosanitary regulations on sound science in conformity with internationally accepted standards. China subsequently has implemented most of these commitments, but the reluctance of Chinese officials to issue import licenses still hampers U.S. exporters.[73]

Apparel and Textiles. The United States has negotiated several bilateral agreements to limit the flow of Chinese apparel and textile exports into the U.S. market. Chinese exporters have tried to circumvent U.S. import quotas by transshipping apparel and textiles through such higher-wage economies as Hong Kong, Taiwan, Macau, and Singapore that do not use their full quotas, and then applying false country-of-origin labels. In January 1994, the United States and China concluded a three-year apparel and textile agreement that severely limited the growth rate of Chinese exports and allowed the United States to reduce the PRC's quotas if Chinese transshipments resumed.[74] This agreement was largely ineffective in stemming the flow of illegal Chinese exports. Consequently, the United States slashed China's cotton underwear quota by 35 percent in May 1995 because illegal shipments through Hong Kong were mislabeled as video rewinders and metal furniture.[75]

After long negotiations, China and the United States concluded a new three-year apparel and textile agreement on February 2, 1997. This agreement reduces China's export quotas in 17 categories. Although overall export quotas were cut by 2.6 percent from the 1994 agreement, some export quotas were slashed severely, including wool fabric (50 percent), print cloth (20 percent), and men's and boy's wool jackets and trousers (10 percent).[76] This agreement also specifies what would happen to China's apparel and textile export quotas after China joined the WTO. Specifically, quotas that remained

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72 In April 1991, the Bush Administration initiated a Section 301 investigation of China's trade practices. In this case, unlike other Section 301 cases that attempted to remove trade barriers against specific products, the purpose was to reform China's entire trading regime. On August 21, 1992, then-USTR Carla Hills threatened to impose $3.9 billion worth of U.S. trade sanctions unless a satisfactory agreement with China was reached by October 10, 1992.

73 Lardy, *China and the World Economy*, pp. 91–93, and Morrison, "China-U.S. Trade Issues," pp. 11–12.

74 Lardy, *China and the World Economy*, pp. 93–96, and Morrison, "China-U.S. Trade Issues," p. 12.

75 Marcus Noland, "China and the International Economic System," Institute for International Economics *Working Paper Series on APEC* No. 95–6, 1995, pp. 5–6.

on China's apparel exports but already had been eliminated on similar exports from other developing countries would be lifted immediately upon accession.[77] At the same time, China agreed to reduce its tariffs on a number of apparel and textile imports, including industrial fabrics, brand-name items, high-end apparel, home furnishings, and drapes, from between 25 percent and 50 percent to between 8 percent and 17 percent.[78]

Intellectual Property Rights. In May 1991, USTR Carla Hills launched a Special 301 investigation alleging that the PRC had not protected patents, copyrights, and trade secrets. In January 1992, China and the United States signed an Intellectual Property Rights MOU settling this investigation. China agreed to strengthen its patent, copyright, and trade secret laws and to improve its intellectual property rights protection for computer software, sound recordings, agricultural chemicals, and pharmaceuticals.[79]

Although China strengthened its intellectual property rights laws, enforcement remained sporadic. Consequently, then-USTR Mickey Kantor launched a second Special 301 investigation in June 1994. After threatening to impose trade sanctions, China and the United States concluded a second Intellectual Property Rights MOU in February 1995 in which China pledged to act to curb piracy immediately and to ensure better enforcement of its laws.[80]

China then closed a number of pirate factories. Some of these plants, allegedly owned by senior PLA officers, reopened. Consequently, then-Deputy USTR Barshefsky warned China that the United States would take "decisive action" if Chinese factories did not stop producing pirated compact discs (CDs).[81] On June 17, 1996, after threatening to impose retaliatory tariffs of 100 percent or more on $2 billion worth of Chinese exports if a satisfactory solution was not reached, then-Acting USTR Barshefsky and China's Minister of Foreign Trade and Economic Cooperation Wu Yi signed an agreement supplementing the 1995 Intellectual Property Rights MOU. This agreement expands the access of U.S.-produced audio and visual recordings to the Chinese market by allowing Chinese publishing houses to contract with U.S. firms to promote artists and to produce and distribute their audio and visual recordings. China also agreed to extend its seven-month crackdown on pirate factories in Guangdong province.[82]

China's enforcement of intellectual property rights improved somewhat during the remainder of 1996; but even though China closed 15 pirate CD factories in 1996, new plants have been smuggled into China. Thus, according to the Intellectual Property Rights Alliance, "The problem of CD production and export is far from resolved." The Motion Picture Association of America has noted that "Chinese enforcement efforts against pirate retail outlets have had a positive effect in some parts of the country. Enforcement actions against illegal manufacturing plants improved in the latter part of 1996, but some facilities

76 "New Textile Deal Lays Out Terms of China's Trade Upon WTO Entry," *Inside U.S. Trade,* Vol. 15, No. 6 (February 7, 1997), pp. 7–8.

77 *Ibid.*

78 "U.S., China Strike Market Access Deal for Selected Textile Exports," *Inside U.S. Trade,* Vol. 15, No. 6 (February 7, 1997), p. 9.

79 Morrison, "China–U.S. Trade Issues," pp. 9–10.

80 *Ibid.*

81 "China Will Delay Abolition of Import Tax Suspension Until April," *Inside U.S. Trade,* Vol. 14, No. 1 (January 5, 1996), p. 5.

82 "IPR Agreement Offers U.S. Audiovisual Firms Limited Market Access," *Inside U.S. Trade,* Vol. 14, No. 25 (June 21, 1996), pp. 18–23.

continue to produce pirate [videos], including some which operate legally during the day and illegally during the night."[83] On December 20, 1996, the Office of the USTR released an upbeat assessment of Chinese enforcement of intellectual property rights: "[T]here are indications of improved enforcement efforts under the U.S.–China [Intellectual Property Rights] Agreements, particularly in Guangdong province." Chinese officials also have improved border enforcement to prevent the illegal importation of equipment to manufacture CDs.[84]

CHARTING THE PATH TO INTEGRATION

Successfully integrating China into the global economy is a challenge for leaders in both Beijing and Washington. International trade and investment have spurred China's economic growth, motivated Beijing to introduce the rudiments of the rule of law, and encouraged it to adhere to international economic norms to win accession to the WTO. Nevertheless, China must overcome serious internal problems to maintain economic growth and to smooth its integration into the global economy. Specifically, it must reorganize its inefficient state-owned industries and restructure its insolvent state-owned financial services firms. International trade and investment can help China solve these two critical problems.

First, China must develop a strategy to reorganize its faltering state-owned industries. Specifically, China must introduce Generally Accepted Accounting Principles, develop a modern system of corporate governance for all SOEs, and relieve SOEs of their education, health care, and pension obligations. Beijing should assume the burden of providing pension and health care benefits to the elderly, the disabled, and orphans, and should establish a national unemployment benefits scheme to assist displaced workers. Provincial and local governments then should assume control of all schools and hospitals currently operated by state-owned enterprises. Housing units should be sold to their tenants. Simultaneously, China should implement a new system of privately managed health insurance plans, disability insurance, and old-age pensions for working-age Chinese. Beijing has decided to retain its ownership and control of 18,000 large and medium-size SOEs; through consolidation and mergers, it should reorganize them into commercially viable firms. Redundant workers must be terminated, and obsolete plants closed. Fiscal and financial system subsidies must be phased out. Large or medium-sized SOEs that cannot be commercially viable must be liquidated. For the remaining 100,000 mainly small SOEs, Beijing should accelerate privatization.

Second, the PRC must develop a strategy to recapitalize its insolvent state-owned commercial banks, policy banks, and insurance company. Reorganizing state-owned industries and introducing accrual accounting will reveal the true extent of insolvency in China's state-owned financial firms. To solve China's looming financial crisis, the People's Bank of China should force China's commercial banks to recognize all of the losses imbedded on their books and then place all of the insolvent banks into receivership. Because most of the bad loans are due to Beijing's policy decisions rather than to the independent decisions of bank management, Beijing should issue new, long-term, market-interest-rate

83 "Major Copyright Associations Criticize Chinese IPR Practices," *Inside U.S. Trade,* Vol. 14, No. 49 (December 6, 1996), pp. 21–22.

84 "USTR Cites Improved Intellectual Property Enforcement in China," *Inside U.S. Trade,* Vol. 15, No. 1 (January 3, 1997), p. 8.

government bonds to the insolvent banks to cover all losses that exceed their combined equity and loan loss reserves. This would cause the PRC's government debt to rise significantly from 12 percent to at least 44 percent of GDP. Simultaneously, Beijing should lift all restrictions on foreign ownership of financial institutions and eliminate all financial regulations that cannot be justified on prudential grounds. The People's Bank of China then could auction the insolvent institutions to domestic and foreign investors who are willing to invest fresh capital in these banks and reorganize, reopen, and operate them on a sound commercial basis.

Washington must work with Beijing to facilitate these sweeping changes. Implementing and obeying WTO trade and investment rules will encourage foreign investment and help China sustain the high rate of economic growth necessary to reorganize state-owned industries and restructure state-owned financial services firms. Joining the WTO will compel China to open its markets to U.S. exports and investment far more rapidly than it otherwise would. That, of course, will create new job opportunities for American workers.

The benefits of WTO accession are not just economic, however. Gradually, the legal changes required for accession to the WTO are shifting Beijing away from arbitrary administrative decrees and bureaucratic caprice toward the rule of law. In the long run, the emergence of the rule of law, along with the development of a large, independent, and financially secure middle class, will foster democratic principles and the greater observance of human rights in China. Therefore, the President should:

- **Cooperate with the European Union and Japan to ensure that China becomes a WTO member on commercially viable terms.** WTO accession is an economic, not a political, act. As the world's largest exporter, the United States has an interest in seeing that China's membership in the WTO is based on a commitment to open its economy to international trade and investment and to adhere to all WTO rules. Close cooperation among the EU, Japan, and the United States will prevent China from playing one against the others in accession negotiations and will increase the leverage of the United States in negotiating with China. At a minimum, the major WTO trading powers must insist that China agree:

    1. **To publish** all of its regulations affecting trade and investment (immediately upon accession);
    2. **To provide** an open and impartial legal process for adjudicating commercial disputes (immediately upon accession);
    3. **To stop** requiring foreign firms to transfer technology to potential Chinese competitors as a condition of investing in the PRC (immediately upon accession);
    4. **To abide** by the WTO Agreement on Intellectual Property Rights (immediately upon accession);
    5. **To dismantle** its trading rights regime, which restricts the firms that may import foreign goods into China or export Chinese goods (within three years of accession);
    6. **To eliminate** all other industrial policies inconsistent with WTO rules (within three years of accession);

7. **To implement** most of its market-access commitments to lower tariffs and remove non-tariff barriers (within three years of accession);
8. **To phase out** remaining tariffs and non-tariff barriers protecting its most sensitive industries in exchange for strong safeguards while the accession protocol is being implemented (within eight years of accession); and
9. **To abide** by the higher WTO standards for developed countries when WTO agreements allow the developing countries to adhere to less strenuous standards (after the accession protocol is fully implemented).

China's accession to the WTO on these terms would advance U.S. interests. The accession protocol would delineate a strict timetable for the PRC to follow in reducing tariffs, removing non-tariff barriers, and changing its domestic economic policies to comply with WTO rules. Although Beijing unilaterally has cut its tariffs and lifted some non-tariff barriers in recent years, these changes may be reversed legally. The accession protocol would require Beijing to adhere to an agreed timetable for trade liberalization and prevent it from implementing new protectionist trade measures.

The United States would be in a much stronger position to persuade Beijing to honor its trade and investment liberalization commitments if the PRC joined the WTO. Over the years, the United States has negotiated a number of bilateral trade agreements with Beijing to improve market access and protect intellectual property. As long as China remains outside the WTO, the only way the United States can pressure Beijing to implement these policies is by threatening unilateral trade sanctions. In bilateral disputes, Beijing can undermine Washington's position by playing off U.S. companies against their competitors in countries that are not threatening trade sanctions (for example, by purchasing commercial jets from Airbus rather than Boeing to pressure Washington to retreat from imposing unilateral trade sanctions). Even if the threat of unilateral trade sanctions does force Beijing to reach a satisfactory agreement with Washington, the MFN principle guarantees that any liberalization benefits from such a settlement will apply to China's other trading partners as well. The bilateral approach creates a "free rider" incentive for the EU, Japan, and other countries to sit back, let U.S. firms take the heat in China for Washington's hardball tactics, and then encourage their companies to exploit the opportunities that these tactics have created.

China's accession, on the other hand, will permit Washington to use the WTO's Dispute Settlement Mechanism to resolve many of its disputes with Beijing. The Dispute Settlement Mechanism is a quasi-judicial system of international arbitration before an impartial panel of trade experts that encourages other countries with similar problems to join the case as co-plaintiffs. Once in the WTO, Beijing could not play one country against another. Instead of resolving trade disputes through power-based bilateral negotiations, dispute panels settle cases by applying and interpreting the appropriate WTO agreement. If any of China's trade policies or practices were found in violation of a WTO agreement, the PRC would be compelled to withdraw the offensive policy or practice within a reasonable time period or face retaliation from other WTO members. By channeling trade disputes with China through the Dispute

Settlement Mechanism, the United States could gain the support of other WTO members instead of continuing to stand alone.

- **Offer to exempt China from the Jackson–Vanik Amendment in exchange for concessions from Beijing.** The President should ask Congress for discretionary authority to exempt China from the Jackson–Vanik Amendment. By granting the President the discretionary authority to exempt China from Jackson–Vanik, Congress would substantially strengthen U.S. negotiating leverage in WTO accession talks with Beijing. The President could offer Beijing unconditional, permanent MFN status in exchange for economic concessions that benefit U.S. exporters and investors. In particular, the United States should insist that Beijing consent to Taiwan's separate accession to the WTO as "The Customs Territory of Taiwan, Penghu, Kinmen, and Matsu" (more briefly, "Chinese Taipei") as a condition for Jackson–Vanik exemption. Taipei applied to join the GATT in 1990 and has progressed further than Beijing in accession negotiations. Although Beijing has agreed that "Chinese Taipei" can enter the WTO at the same time as the PRC, it opposes any earlier entry by Taiwan. Simultaneous accession to the WTO by China and Taiwan within the next 24 months appears likely and would be desirable for all WTO members. Nevertheless, Washington should use the lifting of Jackson–Vanik to press Beijing to refrain from casting a "political veto" over Taiwan's accession if negotiations with the PRC prove slow.

Withdrawing MFN status pursuant to Jackson–Vanik would hurt the United States more than China by increasing tariffs on Chinese exports to Smoot–Hawley levels.[85] After the inevitable retaliation against U.S. exports, direct trade between China and the United States would virtually cease, and China would look to European and Japanese suppliers of capital equipment and high-technology products instead of their U.S. rivals. Moreover, China could skirt higher U.S. tariffs on many of its clothing and footwear exports by transshipping the goods through Taiwan, Singapore, the Philippines, South Korea, and other U.S. allies in the region. Because many of these Chinese exports are made in foreign-controlled factories owned by companies that have headquarters elsewhere in Asia, these firms could add sufficient value to Chinese exports in their home countries (for example, the cloth might be cut in the PRC but sewn into a dress in Taiwan) to avoid higher U.S. tariffs. The difficulties that Washington has encountered in policing its current apparel and textile import quotas shows how easily the Chinese could evade higher U.S. tariffs on apparel and footwear products. At the same time, China easily could identify and exclude such large, high-value U.S. exports as Boeing aircraft or GE electric generators. In the end, it would be American workers who would lose their jobs and suffer the most if MFN status were withheld.

U.S. trade and investment expose the Chinese people to Western ideas of democratic capitalism and human rights. By strengthening the non-state sector, trade and investment reduce Beijing's power over the day-to-day life of the Chinese people. Trade and investment have forced Beijing to introduce the

85 The Smoot–Hawley Act of 1931 raised U.S. tariffs to an extraordinarily high level, setting off a trade war that many economists believe turned an otherwise minor recession into the Great Depression.

rudimentary elements of the rule of law into China's economic system; over time, they speed the development of an independent and financially secure middle class that will force Beijing to liberalize. In South Korea, Taiwan, and Thailand, a large middle class had to emerge before the people could challenge their authoritarian governments to democratize. The course of events in the PRC over the next generation is likely to be similar. Therefore, denying China MFN status and thereby diminishing U.S. trade and investment ties would slow China's political evolution and delay the changes that human rights proponents hope to achieve. Not only would it fail to help Chinese who suffer human rights abuses, but it also would inhibit the rise of a middle class that could function as an internal force for change.

Jackson–Vanik harms U.S. interests in other ways as well. It was designed to encourage the Soviet Union and its Eastern European satellites to lift restrictions on Jewish emigration to Israel and the United States. It was never intended to address the many bilateral issues that congressional opponents of MFN status for China seek to raise. Jackson–Vanik is a blunt instrument that does not discriminate between the actions of Beijing bureaucrats and PLA officials and those of ordinary Chinese businessmen, farmers, and workers. If U.S. policymakers want to apply economic sanctions, they should target them specifically at PRC government agencies and the PLA.

Finally, Jackson–Vanik weakens the U.S. bargaining position in the WTO accession talks with China. By preventing the President from granting China unconditional, permanent MFN status, it renders the United States unable to take advantage of the trade concession that China made in its accession protocol. Instead, the President would be compelled to conclude a separate, probably less favorable bilateral trade pact with Beijing that parallels China's WTO accession protocol. In the current political environment, it is unlikely that China can be exempted from the Jackson–Vanik Amendment. Therefore, the policy objective for 1997 should be renewal of the MFN waiver. Once the uncertainties of Hong Kong's reversion to Chinese sovereignty are resolved, the President can work with Congress for Jackson–Vanik exemption in 1998.

- **Evaluate any proposed economic sanctions against China very carefully.** U.S. leaders need to develop a way to distinguish between those economic sanctions that have some realistic prospect of achieving their objectives and those that merely please domestic political audiences with no hope of success. Although not exhaustive, the following questions may serve as a filter. If the answer to any four of these five questions is negative, the proposed sanction would do little to advance U.S. interests and should be discarded:

  1. **Is the objective** of any proposed economic sanction both limited and conceivably achievable?

  2. **Does the United States** have a monopoly advantage it can exploit against the target country, and will other countries cooperate with it to impose the sanction in the event it lacks such a monopoly advantage?

  3. **Is the probable impact** on the target country great enough to persuade it to change its policies?

4. **Is the probable impact** on the U.S. economy small enough not to engender significant domestic opposition?

5. **Does the proposed sanction address** the capacity of a hostile target country to threaten U.S. security interests?

Applying unilateral economic sanctions against China would be challenging. In response to the Tiananmen Square massacre, Congress pressured Presidents Bush and Clinton to impose sanctions unilaterally against the PRC, both to protest China's human rights violations and to encourage Beijing to democratize and observe internationally accepted norms of human rights. Unilateral sanctions alone, however, are unlikely to secure the objective of full democracy in China in the foreseeable future. Without a viable opposition in place, the Communist Party will not surrender its monopoly on political power voluntarily, no matter what economic sanctions are applied. Except perhaps in certain armaments, U.S. firms do not have a product or technology monopoly the United States could exploit through economic sanctions; unilateral sanctions merely would cause China to switch from U.S. to European and Japanese exporters that are more than willing to sell China whatever it wants.

Unilateral economic sanctions may be appropriate in some circumstances, however. For example, refusing to sell nuclear weapons or missile technology to China in order to pressure it to abide by multilateral nuclear weapons and missile control regimes would pass through the filter. In this case, there is a clear and achievable policy objective that does not threaten the existence of China's current government. Although the United States does not have a monopoly in nuclear weapons or missile production, the number of producing countries is small, and they may be willing to cooperate with Washington. China needs dual-use technologies that only the United States and a few other countries can supply. On the other hand, enforcing an export ban on such technology is not likely to harm the U.S. economy sufficiently to prompt a strong domestic political lobbying effort to get the sanctions lifted. Thus, a ban on exports of nuclear weapons and missile technology in conjunction with other diplomatic initiatives could persuade the leadership in Beijing to adhere to international nuclear weapons and missile proliferation regimes.

- **Monitor closely China's implementation of existing bilateral trade and investment agreements to prevent any backsliding.** China's implementation of existing trade and investment agreements has been uneven. In general, Beijing has honored its bilateral commitments to reduce tariffs and to open markets to U.S. exports, but it has a spotty record on enforcing intellectual property rights. Because enforcement appears to improve when it receives high-level outside attention, the Clinton Administration must continue to watch Beijing's efforts to close pirate CD and software factories and to stem the export or sale of pirated materials.

CONCLUSION

Integrating China into the global economy is a major policy challenge for the United States. Because of its economic transformation and rapid economic growth, China is becoming a major international trading power, yet it remains outside the legal framework governing the world's trading system. The PRC seeks accession to the World Trade Organization. Accession, however, must be on commercially viable terms that push Beijing to restructure its insolvent state-owned industries and recapitalize its state-owned financial institutions while simultaneously creating new markets for U.S. exports.

The United States also must settle a number of bilateral trade questions with Beijing. Americans want a level playing field, with access to Chinese markets that is more or less equivalent to the access China now enjoys to U.S. markets. Having China in the WTO on appropriate terms will facilitate this. Withdrawing MFN would damage U.S. interests just as it would damage those of China. Moreover, it would be a devastating blow to Hong Kong's economy just when that territory is at its most vulnerable, and would harm Taiwan as well. U.S. trade and investment expose the Chinese people to Western concepts of democratic capitalism and human rights.

To expand trade and investment, the PRC has been forced to introduce the rudimentary elements of the rule of law. Over time, this and the development of a large, independent, and financially secure middle class will promote the democratization that so many human rights activists seek. Washington must refrain from employing unilateral economic sanctions that would harm the interests of U.S. businesses without achieving their stated policy objectives. A China that shows by its actions that it wants to play by generally accepted international rules, and to abide by international codes of conduct and provisions for the peaceful resolution of conflicts, is exactly the kind of China the United States wants to see. A China truculent and bitter as a result of its exclusion from the developing global economy is not in the interest of the United States. Neither is a China that employs its growing wealth for external adventures.

Although integration into the global economy marks the pathway to responsible international citizenship, further steps along that path are required. Moving from a Stalinist or Maoist command system to a more or less free-market economy will dissolve totalitarianism, if for no other reason than because the rule of law becomes a necessary environment for economic growth. But more is required to create a peace-loving democracy, and the United States should not delude itself on that point. The birth of political democracy is brought about by the demands of freedom-seeking people. U.S. trade and investment can help foster those ideals. So, too, can U.S. educational and training institutions.

As South Korea, Taiwan, and Thailand have shown, it takes decades to build a democracy, and there are many bumps along the way. In dealing with the Soviets, President Reagan said, "Trust, but verify." In the case of China, U.S. policymakers would do well to adopt a similar formulation: "Trade, invest, and teach—but keep your powder dry."

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86 This study has been adapted from Robert P. O'Quinn, "Integrating China into the World Economy," in Kim R. Holmes and James J. Przystup, eds., *Between Diplomacy and Deterrence: Strategies for U.S. Relations With China* (Washington, D.C.: The Heritage Foundation, 1997).